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No. 93-1710

IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

PHILIP MORRIS INCORPORATED
(d/b/a PHILIP MORRIS U.S.A.),
Petitioner,

v.

CABARRUS COUNTY, NORTH CAROLINA,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of North Carolina

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF OF COMMITTEE ON STATE TAXATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

KENDALL L. HOUGHTON
Counsel of Record
WILLIAM D. PELTZ
ELIZABETH C. BURTON
Chair and Vice Chair, Lawyers' Coordinating Subcommittee
COMMITTEE ON STATE TAXATION
122 C Street, N.W.
Suite 330
Washington, D.C. 20001
(202) 484-5222

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MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE*

The Committee on State Taxation ("COST") hereby respectfully requests leave to file a Brief as *Amicus Curiae* in Support of Petitioner. The interest of COST as *amicus curiae* is described *infra* at Brief, p. 1. Despite COST's qualifications to submit an *amicus* brief, Counsel for Respondent has refused to grant permission to file such a brief, citing inability to meet with his client prior to June 6 (several days after the deadline for filing this brief) to secure a decision in this regard. However, in the absence of such permission there are at least two reasons why this motion should be granted.

First, with respect to the Petition filed in this case, COST has additional observations to make concerning the Due Process implications of the property tax audit scheme being challenged herein. A full exposition of the

controversy and the potential ramifications of this case by each interested and eligible *amicus* is ultimately to the benefit of the Court in its administration of certiorari writs.

Second, in this regard, Philip Morris Incorporated is but one of many members of COST that face audits nationwide by local taxing jurisdictions which utilize independent contract auditors compensated on a contingent fee basis. COST has monitored the development of this practice for several years and is uniquely qualified to comment on the broader concerns and potential consequences of such a practice.

Respectfully submitted,

KENDALL L. HOUGHTON
Counsel of Record
WILLIAM D. PELTZ
ELIZABETH C. BURTON
Chair and Vice Chair, Lawyers' Coordinating Subcommittee
COMMITTEE ON STATE TAXATION
122 C Street, N.W.
Suite 330
Washington, D.C. 20001
(202) 484-5222

Dated May 27, 1994

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On Petition for a Writ of Certiorari to the Supreme Court of North Carolina

BRIEF OF COMMITTEE ON STATE TAXATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

INTRODUCTORY STATEMENT

This brief is submitted by the Committee on State Taxation as *amicus curiae* in support of Petitioner in the above-captioned matter. Written consent of the Petitioner has been obtained and filed with the Clerk of the Court; the Motion for Leave to File a Brief *Amicus Curiae* is made because the Respondent has refused to likewise grant permission to file a brief.

INTEREST OF *AMICUS CURIAE*

The Committee on State Taxation ("COST") is a non-profit trade association that was organized in 1969 as an advisory committee to the Council of State Chambers of Commerce. COST, which was separately incorporated on

January 1, 1992, has a membership of over 420 major multistate corporations, engaged in interstate and international business. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multijurisdictional entities.

Many of COST's members are engaged in business in states where local taxing jurisdictions have employed independent contractors to perform their administrative and audit functions relating to property taxes, sales and use taxes, and other taxes imposed at the local level of government. While the behavior of Cabarrus County, North Carolina lies at one end of the continuum of involvement of outsiders in the local tax administration process, as discussed in this Brief, the number of variations on the theme of utilization of independent contingent fee auditors is surprising and confusing. COST's member corporations are often the largest taxpayers in a local jurisdiction, and bear the greatest brunt of any unconstitutional or unequitable taxing scheme implemented by that jurisdiction. COST is concerned with the Due Process implications of such practices, wherever they may occur, and hence has an interest in this case.

SUMMARY OF ARGUMENT

A broad range of relationships can be structured between local governments and independent third parties, in order to facilitate the government's completion of its tax administrative and audit functions. Certainly, some arrangements will imbue the independent contractors with greater agency powers than others; but in every case, the relationship is circumscribed by the basic Due Process requirements that the governing body engage in "fair play" with, and provide "substantial justice" to, its taxpayers. In this case, the relationship violates Due Process principles in at least two respects:

(i) the contract auditors are permitted to choose their own audit targets, rather than being assigned random targets;

(ii) contingent fees are utilized to compensate contract auditors whose proposals are issued as "discoveries" to taxpayers; and

(iii) these discoveries, rather than the tax liability ultimately collected, are the measure of the fee owed them by Cabarrus County, thus resulting in the creation of a financial interest on the part of the County in the preservation of a sufficient tax liability to at least cover the contingent fee.

Contrasting Cabarrus County's practice to the approved practice of paying contingent fees to informants who assist law enforcement officials in state prosecutions illustrates the constitutional infirmities of the practice at issue in this case. First, a compelling interest in preserving the integrity of the law enforcement system justifies the use of contingent fees to compensate informers. Second, where a contingent fee informant's testimony is used in a state prosecution, ample Due Process protections are afforded to the defendant, including: (i) the use of a jury, (ii) full submission to the jury of the question of credibility of such a witness (through cross examination of the witness, notification of the contingent fee arrangement, and instructions to the jury), and (iii) submission of other corroborating testimony at trial. None of these specific Due Process protections are afforded a Cabarrus County taxpayer who is audited by a contingent fee contract auditor, nor may the structural bias against the taxpayer be countered in any other way by first level review of a proposed assessment of Cabarrus County property taxes.

The variety of theories put forth by the State courts, both in support and condemnation of the practice of paying contract auditors contingent fees, illustrates the need for a clear resolution by this Court of the Due Process principles applicable in this arena.

ARGUMENT

I. ON THE SPECTRUM OF LOCAL JURISDICTION PRACTICES OF UTILIZING INDEPENDENT AGENTS TO PERFORM TAX ADMINISTRATIVE AND AUDIT FUNCTIONS, THE COMPENSATION OF SUCH AGENTS BY CONTINGENT FEES CLEARLY VIOLATES DUE PROCESS

There is a broad spectrum of relationships which may be structured between counties, municipalities, or other local governments and independent third parties, for purposes of accomplishing local tax administrative functions. Some of the relationships, as described below, pose no grounds for objection by taxpayers. However, some relationships offend the Due Process Clause tenets of "fair play" and "substantial justice," applicable to the taxpayers of both State and local jurisdictions. *International Shoe Co. v. Washington*, 326 U.S. 310 (1945).

The spectrum of relationships between local jurisdictions and independent agents which COST has identified, based upon a study of case law and current local practices reported to it by its members, is presented below in order from the clearly constitutional (at least on its face) to the clearly unconstitutional schemes:

1. Pure Governmental Administration/Auditing (No Relationship with Independent Agents):

This practice is obviously the norm for state and local tax administration and auditing of taxpayers. However, while state departments of revenue generally have sufficient staff to perform all such functions, local jurisdictions with responsibility for tax collections and audits may be less well-staffed and hence resort to outside assistance. The various manners in which such contract auditors are employed and compensated are discussed below.

2. Contract Auditor Examines Only Materials Filed with Local Jurisdiction/No Contingent Fees:

In this case, a limited agency has been established. For instance, a local jurisdiction might employ contract as-

sistants "not to do audits, but rather to compare details written into the different governmental required reports." *Union Pacific Resources Co. v. State*, 839 P.2d 356, 374 (Wyo. 1992). To the extent such limited, essentially non-audit, activity is not compensated on a contingent fee basis, no Due Process question arises.[1]

3. Contract Auditor Examines Internal Records of Taxpayer/No Contingent Fees:

This arrangement extends the authority of the contract auditor, to directly contact a taxpayer and audit its books and records. In *General Motors Corporation v. State Tax Commission*, 200 Mich. App. 117, 504 N.W.2d 10 (1993), *appeal dismissed*, 509 N.W.2d 157 (Mich. 1993), the City of Warren hired an outside accounting firm to conduct an audit of General Motors, a taxpayer believed by the City to have underreported its taxable personal property. The Court of Appeals of Michigan held that state statutory authority existed for "[t]he commission or any duly authorized representative thereof" to examine the property, books and records of any person owning property liable to assessment for taxes, and properly distinguished the *Sears, Roebuck & Co. v. Parsons*, 260 Ga. 825, 401 S.E.2d 4 (1991), and *Philip Morris* (Court of Appeals) decisions:

> Unlike those cases, the present case does not involve a contingent fee arrangement, nor is [the contract auditor] afforded the discretion to choose the target of the audit.

General Motors, 504 N.W.2d at 12.

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[1] In fact, the above-cited *Union Pacific Resources* case did involve contingent fees and thus belongs further down the spectrum toward the point where this case lies.

4. Contract Auditor Picks (Or Is Assigned [2]) Audit Target/Is Paid a Contingent Fee—

(i) based on tax liabilities ultimately collected; or

(ii) based on what is "discovered" or proposed as a liability by contract auditor:

These are the most egregious arrangements between local jurisdictions and contract auditors. The taxing authority essentially "leverages" jurisdictional tax revenues by paying contract auditors with the very funds raised by them through audit assessments. In the first instance above, the leveraging is less direct although still oppressive. However, the offense to Due Process in the second instance, which in fact is the scheme at issue in this case, is patent. The agent's financial interest, and hence the local government's financial interest, in the outcome of the proceedings is established from the moment the contract auditor's proposals are issued as a "discovery." The "discovery" of taxable property or undervaluation of same is the event triggering the liability of the County to the contract auditor, in the amount of 35% of that discovered amount, regardless of subsequent reductions in the tax liability proposed, due as a result either of informal conferences/settlements or of formal appeals. The resultant structural bias to find sufficient tax due to at least cover the contingent fee precludes a fair and impartial assessment of any taxpayer so identified and audited.

Nevertheless, the Supreme Court of North Carolina barely gave lip service to the constitutional principles in-

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[2] As noted in the Petition, p. 4, permitting the contract auditors to identify their audit targets is at least likely, if not guaranteed, to result in a less than "random" sampling of taxpayers within the jurisdiction, particularly if the auditors are not subject to a limit on the contingent fees they can earn. Likewise, these "deep pocket" audit targets are very likely to be subjected to more aggressive and less impartial audits. However, both practices are included together for the sake of brevity, and because the more extreme practice is the one at issue in this case.

volved in this case; and other State courts have come out with conflicting positions on this question. The Georgia Supreme Court recognized the public policy and Due Process issues at stake and stated in *Sears, Roebuck & Co. v. Parsons,* 401 S.E.2d at 5: "The people's entitlement to fair and impartial tax assessment lies at the heart of our system, and, indeed, was a basic principle upon which this country was founded." *But see Dillon Stores v. Lovelady,* 253 Kan. 274, 855 P.2d 487, 491 (1993). In *Dillon Stores,* contingent fee contracts were held not to violate Kansas public policy. There, the contract auditors chose audit targets and were compensated on an hourly rate basis with a maximum 35% contingent fee keyed to additional taxes assessed by the county. (This form of compensation is essentially an hourly rate, *limited* by a measure of the tax found.)

If this Court believes that the concerns over systemic fairness and undue deprivations of property that underlie the Due Process Clause are wrongly disregarded by Cabarrus County and other local jurisdictions that utilize contingent fee compensation arrangements, then it should clarify this fact for taxpayers and State and local governments alike.

II. A COMPARISON OF THE USE OF CONTINGENT FEES TO COMPENSATE INFORMANTS IN STATE CRIMINAL PROSECUTIONS ILLUSTRATES THE IMPROPRIETY OF USING SUCH A COMPENSATION SCHEME WITH RESPECT TO STATE TAX ADMINISTRATIVE AND AUDIT FUNCTIONS

The constitutional infirmities of contingent fee compensation of contract auditors become manifest when that practice is contrasted with the generally approved practice of compensating informants in state prosecutions by means of contingent fees.

It has long been the practice of state and local law enforcement agencies to utilize contingent fee arrangements to secure the assistance of informers in identifying,

arresting and prosecuting individuals involved in criminal activity. Challenges to this version of the "bounty hunter" practice have been made on both public policy and due process grounds, but rarely have such challenges been successful. Courts that have analyzed the propriety of contingent fee arrangements with informants have affirmed the necessity of such arrangements to effective law enforcement, as a matter of public policy. *See, e.g., Williams v. State,* 463 So.2d 1064 (Miss. 1985); *State v. Maddasion,* 130 Ariz. 306, 636 P.2d 84 (1981); *People v. Mills,* 40 Ill.2d 4, 237 N.E.2d 697 (1968) (noting additionally that the type of individual who can assist law enforcement officials in criminal cases generally has not led a blameless life and must be enticed into giving such assistance). Thus, a compelling interest exists in this context to justify the use of contingent fee compensation. Of course, concomitant with this conclusion, such courts note the procedural Due Process protections that are afforded defendants in cases where contingent fee informant testimony is utilized, including: (i) the use of a jury, (ii) full submission to the jury of the question of credibility of a contingent fee witness (through notification of the contingent fee arrangement, cross examination of the witness, and detailed jury instructions), and (iii) submission of other corroborating testimony at trial. *See* 57 A.L.R. 4th 643, sec. 12[c] (citations omitted).[3]

Even in the context of state prosecutions, the use of contingent fees has been disapproved by courts as violative of Due Process if the "ever present danger of governmentally subsidized perjury," *see United States v. Ladley,*

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[3] A similar scheme has been instituted by the Internal Revenue Service. The IRS Informant Program is embodied in I.R.C. § 7623, which contains the terms for rewarding individuals who provide information on possible noncompliance with federal tax laws. Like the state informants program, and *unlike* the Cabarrus County contract auditors program, the individual against whom such information is provided faces potential criminal prosecution and is afforded ample Due Process protections.

517 F.2d 1190 (9th Cir. 1975), is realized. For instance, in *State v. Glosson,* 441 So.2d 1178 (Fla. App. 1st Dist. 1983), *aff'd.*, 462 So.2d 1082 (Fla. 1985), the informant was paid a contingent fee upon successfully making criminal cases against others to whom he sold controlled substances supplied by the local sheriff's department; and in this case, the contingent fee testimony constituted the entire case against the defendant. The Supreme Court of Florida prohibited the creation of such a direct financial stake in criminal convictions, on grounds that there were few situations imaginable with more potential for abuse of a defendant's Due Process rights.

The practice of compensating informants in state prosecutions has generally been deemed constitutional, because defendants' Due Process rights are afforded protections that counterbalance the potential bias to them. By contrast, the practice adopted by Cabarrus County in this case of compensating contract auditors on a contingent fee basis is clearly violative of taxpayers' Due Process rights.[4]

First, there is no compelling interest on the part of local jurisdictions in enforcement of state tax laws that justifies the use of contingent fee auditors. The tax system in this country has been structured as an "honor system" based upon self-assessment, and the instances of egregious taxpayer behavior do not justify "bounty hunting" of taxpayers who are remiss in their tax compliance. Rather, as most of the state jurisprudence in this area recognizes (and as the lower courts in North Carolina concluded in this case), Due Process mandates the fair and impartial assessment of all taxpayers—a mandate

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[4] In fact, the Cabarrus County practice is fraught with even more potential for abuse than the practice condemned in *State v. Glosson, supra.* Here, the contingent fee award is paid on the mere accusation (accusation being the "discovery" of taxable or undervalued property that results in the mailing of a notice of proposed additional tax liability), versus a successful prosecution.

that is inconsistent with creation of a financial stake in the outcome of audits on the part of auditors. *See Sears, Roebuck, supra.*

Second, in the context of this case, there are *no* significant procedural Due Process safeguards available to County taxpayers who are subject to a "discovery" of taxable property or undervaluations as the result of a contract auditor's proposals. None of the protections afforded criminal defendants subject to contingent fee witness testimony are available to the Cabarrus County taxpayer who is audited by a contingent fee contract auditor. As noted in the Petition, pp. 17-19, the first level review of a proposed assessment cannot remove the bias against the taxpayer that results from the financial interest in the audit outcome that both the contract auditors and the County hold. Even without addressing the potential abuses of authority that may occur in this context (*e.g.*, intentional overvaluation of reported property, or "discovery" of property that is not in fact taxable), the near impossibility of receiving an adjustment in aggressive proposed assessments made by contingent fee auditors, who will in any event be entitled to payment by the County of a percentage of such amounts discovered by them, renders such a practice in the arena of state and local taxation void under the Due Process Clause.

CONCLUSION

For the reasons set forth above, the Committee on State Taxation respectfully requests that the Court grant a writ of certiorari in this case.

Respectfully submitted,

KENDALL L. HOUGHTON
Counsel of Record
WILLIAM D. PELTZ
ELIZABETH C. BURTON
Chair and Vice Chair, Lawyers' Coordinating Subcommittee
COMMITTEE ON STATE TAXATION
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